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# Formal Legal Theory and the Surrender of Political Control over Monetary Policy: What Can Ulysses' Journey to Ithaca Teach Argentina about Appropriate Legal Form

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# Formal Legal Theory and The Surrender of Political Control over Monetary Policy: What Can Ulysses' Journey to Ithaca Teach Argentina about Appropriate Legal Form?

Juscelino F. Colares†

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## Introduction

Monetary policy is a fundamental part of a nation's economic decision-making. Probably the most direct manner in which it impinges upon us as individuals is in the setting of interest rates. These rates greatly affect our choices between consumption and saving both in the present and at various periods in the future.<sup>1</sup> Mortgages, college loans, and even (to some) everyday consumption decisions are examples of how interest rates may become central in modern life. Yet, despite their ubiquity in the lives of those living in the West, interest rate decisions have been placed outside of the core of political decision-making. Western democracies have vested decision-making authority for setting the level of interest rates in an independent actor: central banks.<sup>2</sup> This institutional design, it turns out, is largely a formal legal arrangement, and a good one at that.<sup>3</sup>

This Note applies the legal theory of form, posited by Robert S. Summers,<sup>4</sup> to an area usually thought of as being dominated by substance: monetary policy. It focuses primarily on the question of the cumulative effects of choices of (legal) form in carrying out monetary policy. It posits that the successful reduction of the perverse influence of politics in the monetary policy of Western democracies can be credited to the choice of a specific legal form. This Note's primary hypothesis is that a certain kind of legal form deserves a major portion of the credit for the success that

1. See F. A. Hayek, *Time-Preference and Productivity: A Reconsideration*, 7 *ECONOMICA*, Feb. 1945, at 22, 22–25.

2. For a more detailed account of why the mature democracies of the West have turned to central bank independence, see discussion, *infra* subsection II (A)–(B). For deeper theoretical (i.e., substantive) treatment, see ALBERTO ALESINA & GUIDO TABELLINI, *A POSITIVE THEORY OF FISCAL DEFICITS AND GOVERNMENT DEBT IN A DEMOCRACY* 1–38 (Nat'l Bureau of Econ. Research, Working Paper No. 2308, 1987), available at <http://papers.nber.org/papers/w2308.pdf>; Alberto Alesina & Jeffrey Sachs, *Political Parties and the Business Cycle in the United States, 1948–1984*, 20 *J. MONEY, CREDIT & BANKING* 63–82 (1988); Alberto Alesina & Lawrence H. Summers, *Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence*, 25 *J. MONEY, CREDIT & BANKING* 151–62 (1993).

3. See, e.g., *Beware of Heroes: Faith in Central Banks Tends to Overshoot - Just like Stockmarkets*, *ECONOMIST*, Apr. 14, 2001, at 17–18 [hereinafter *Beware of Heroes*] (arguing that central banks have done a “superb job, pushing inflation rates to 30-year lows”).

4. See generally ROBERT S. SUMMERS, *FORMAL LEGAL THEORY* (forthcoming 2003) (draft on file with author) (defining, explaining, and applying the concept of form in legal analysis).

these democracies have had in achieving the goals of price stability and sustainable economic growth.

In broad strokes, Summers' theory of legal form posits that at the most fundamental level a law-abiding, democratic society's most vital decisions are formal in nature. Summers argues that the uncontroverted values expressed in the most basic principles of the rule of law are essentially formal, for they establish: "(1) that basic social relations are to be governed by law"<sup>5</sup>—meaning that whatever its substance, law normally prevails over any contrary substantive reasons (a highly formal value); "(2) that such law is generally to take the form of clear rules"<sup>6</sup>—meaning that clarity, regardless of content, must occur so that addressees can understand and decide to comply; "(3) that officials are subject to the law, too"<sup>7</sup>—meaning that substantive differences between inhabitants and officials should not displace generality, a clearly content-free legal value; and (4) "that [all addressees] are entitled to due process of law"<sup>8</sup>—meaning that all addressees, regardless of differences in status, occupation, etc. are entitled to the formalities of due notice and opportunity for hearing. Thus, at its most fundamental level, law in the democratic societies of the West has a content-independent, formal nature.<sup>9</sup>

Adopting Summers' conception of law as essentially formal and content-independent, this Note then explores the extent to which societies have gotten form right, and when they have not. For purposes of this Note, let us characterize appropriate legal form as that which yields substantive content that furthers the basic values of democracy and the rule of law, namely rationality, predictability, fairness and accountability.<sup>10</sup>

In the interest of space and clarity, this Note will evaluate the impact of form solely in the monetary policy area. This area of public policy is particularly well-suited for this task because "good" or "bad" form can be detected by looking at the effects of any given formal legal arrangement in terms of its result. Form will be deemed good or appropriate when economic growth, social well-being and political stability follow its adoption.<sup>11</sup> Therefore, this Note will compare and contrast the experience of Western democracies having independent central banks with that of Argentina, a

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5. ROBERT S. SUMMERS, *The Form of Law-like Governance—Rule of Law*, Chapter 11 in *FORMAL LEGAL THEORY* (forthcoming 2003) (draft at 2–3, on file with author).

6. *Id.*

7. *Id.*

8. *Id.*

9. See Manuel Atienza, *Preface to the First Edition* of ROBERT S. SUMMERS, *LA NATURALEZA FORMAL DEL DERECHO* (2001).

10. Though a simplification, this characterization largely covers Summers' description of the values that may be realized through the use of appropriate form. See ROBERT S. SUMMERS, *Primary Concepts and General Approach*, Chapter 2 in *FORMAL LEGAL THEORY* (forthcoming 2003) (draft at 39–44, on file with author).

11. Our definition of appropriate form in the monetary policy area can be shown to be a special case of Summers' broader definition of appropriate form as "form sufficiently designed to serve the relevant purposes which may, in turn, be further analyzed in terms of policies, fundamental political values, and general legal values associated with the rule of law." *Id.* at 29.

country that chose to forego sovereignty over monetary policy altogether. By highlighting the differences in the formal designs adopted in these two monetary policy regimes, this Note intends not only to sharpen the readers' understanding of the differences between good and bad form, but also to explain how legal form strongly impacts policy-content.

Section I provides the theoretical background for this Note by describing and explaining the theory of legal form. Section II explains why modern Western democracies have opted for restricting the role of politics in the monetary policy area by granting greater autonomy (if not independence altogether) to presumably nonpolitical entities—central banks. Toward that end, this Note will utilize a somewhat unorthodox methodological approach—let us call it “Ulyssesian Methodology.” This approach is used by James Buchanan and his colleagues in the Constitutional Political Economy School.<sup>12</sup> This Note will refer to the Ulyssesian dilemma of having to decide between two time-inconsistent goals: that of listening to the songs of the Sirens and that of returning home safely after a long war. Throughout this Note, Ulysses and the approach he took to cope with his dilemma will be looked upon as the “paradigmatic case of self-binding.”<sup>13</sup> This Note will draw parallels between Ulysses' dilemma and a dilemma that presents itself in the carrying out of macroeconomic policy in all modern societies—both of which require the use of some method of self-binding.<sup>14</sup>

Section III addresses how choosing to surrender political control of monetary policy largely corresponds to a choice of good legal form. Many attribute the economic vibrancy of the West in the last three decades to a choice of macroeconomic architecture that created a stable economic environment highly conducive to economic certainty.<sup>15</sup> To explain how good legal form—illustrated here by independent central banks—can contribute to good policy content—resulting in macroeconomic certainty and stability—this Note will rely on Summers' linear progression analysis as a

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12. In the words of its founder and economics Nobel laureate, James Buchanan: Constitutional political economy is a research program that directs inquiry to the working properties of rules, and institutions within which individuals interact, and the processes through which these rules and institutions are chosen or come into being. The emphasis on the choice of constraints distinguishes this research program from conventional economics, while the emphasis on cooperative rather than conflictual interaction distinguishes the program from much of conventional political science.

James M. Buchanan, *The Domain of Constitutional Political Economics*, 1 CONST. POL. ECON. 1 (1990). Note, however, that while the narrative approach I take derives from the Constitutional Political Economy approach, I ground my analysis on the legal theory of form.

13. See JON ELSTER, ULYSSES UNBOUND: STUDIES IN RATIONALITY, PRECOMMITMENT, AND CONSTRAINTS 275 (2000).

14. Note that the Ulysses metaphor is not strange to Summers' lifetime work as a contracts scholar. For, as Elster suggests, a simple example of self-binding “is the use of contract law to make promises credible.” See *id.* at 272.

15. See *Navigators in Troubled Waters*, ECONOMIST, Sept. 25, 1999, at 3–6; *Beware of Heroes*, *supra* note 3, at 75.

method of showing the cumulative effects of choices of form.<sup>16</sup>

Section IV of this Note discusses another example of self-binding in the monetary policy area, which takes on an entirely different form than central bank independence: the strict currency board. The Argentine government adopted this formal legal arrangement in 1991 as an attempt to control inflation, introduce economic stability, and, most importantly, reestablish the government's long-lost credibility in economic matters.<sup>17</sup> Contrasting this mode of self-binding with central bank independence, this Note intends to illustrate how inappropriate form led to bad policy content. The Note then concludes with both a lesson and a warning: while much of public policy is inherently substantive in nature, if legislators and policy-makers choose to ignore the properties of legal form, particularly how such properties create and mold legal content, they do so at their peril.

## I. What Counts as Form?

### A. The Concept of Form in Legal Analysis

The concept of form is both the starting point and the means by which Summers develops a legal theory that does not reduce law to a universe defined merely by rules or norms.<sup>18</sup> To Summers, the positivists'<sup>19</sup> rule-oriented approach offers a limited view of the legal universe and surely cannot fully account for the presence of formal values in the fundamental notion of "rule of law."<sup>20</sup> Summers thus develops a legal theory that accounts for the fundamental values expressed in the rule of law—which are formal in nature—while providing an interpretation of how these values are articulated by formal and non-formal elements in the legal world as part of a multifaceted social activity commonly called "the law."<sup>21</sup>

The role of form both in shaping and in giving content to the law is best perceived by observing the fact that Western democratic societies seem to share some core features and values in their conceptualizations of

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16. Summers' linear progression analysis illustrates how early choices of form influence other legal choices further down the legislative/implementive path, and also impact on substantive content of legal concepts/actions. This is what we mean by "cumulative effects of choices of form." See SUMMERS, *Cumulative Effects of Choices of Form*, Chapter 10 in *FORMAL LEGAL THEORY* (forthcoming 2003) (draft at 2, on file with author).

17. See, e.g., *Dollar Mad? Argentina's troubles have increased doubts about currency boards*, *ECONOMIST*, Oct. 27, 2001, at 72 [hereinafter *Dollar Mad?*].

18. See Atienza, *supra* note 9.

19. The Legal Positivists are represented mainly by Hans Kelsen and H.L.A. Hart and their followers. See generally H.L.A. HART, *THE CONCEPT OF LAW* (2d ed. 1994) (discussing the philosophical foundations of legal positivism in American law); HANS KELSEN, *GENERAL THEORY OF LAW AND STATE* (1945) (discussing the philosophical foundations of legal positivism in the civil law system).

20. See, e.g., ROBERT S. SUMMERS, *The Form of Law—Like Governance—Rule of Law*, Chapter 11 in *FORMAL LEGAL THEORY* (forthcoming 2003) (draft at 11–16, on file with author) (criticizing Kelsen and Hart and outlining the formal principles of the rule of law).

21. See *id.*

the rule of law, and that these features are essentially formal in nature.<sup>22</sup> Take, for example, the notion that social relations ought to be governed by law, that law should be expressed in the form of legal rules, or that like addressees, public officials are also subject to the law. All these basic principles of the rule of law are legal expressions of form, that is, they describe *how* social relationships ought to be structured and *how* different social interactions are going to be approached from a legal perspective, but not the specific content of the law applicable in a given circumstance. In Summers' words, these principles "do not directly determine the specific content of legal relations between legal persons . . . [i]nstead, they specify the general shape of . . . law that in turn determines the content of these relations."<sup>23</sup> This is what he means by saying that the principles of the rule of law, in the democratic societies of the West, have a substantive-independent, formal nature.<sup>24</sup>

Having a substantive-independent nature means that legal form is not subject to the boundaries that normally limit the reach of substantive legal concepts.<sup>25</sup> The consequences of this insight are profound. First, it permits us to see that form can express itself systemically, that is, across different content areas.<sup>26</sup> Second, by organizing and integrating different legal phenomena under an umbrella of formal principles, form establishes the contours of different areas of the legal universe.<sup>27</sup> Legal phenomena such as institutions, statutes, contracts, interpretive methodologies, and operational techniques are manifestations of the rule of law at lower levels

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22. Summers sums up the essential and inherently formal principles of the rule of law as follows:

[S]o far as feasible, the law is to take the form of general rules; those rules are to be clear and definite; any new law is to be publicly promulgated or otherwise made publicly accessible; the citizenry is generally to have advance notice of the effective date of new law and ready access thereto; new written law is generally to be prospective rather than retrospective in operation; bodies of law are to be free of conflicts; all law is to be interpreted or applied in accord with appropriate methodologies generally understood in advance; prior to any significant denial of [a] claimed right, adverse grant of remedy, or imposition of a sanction, the party to be adversely affected is to have an opportunity to contest such action before an independent and impartial body in accord with due process; and so on.

ROBERT S. SUMMERS, *Features Unifying Phenomena into the Form of a System*, Chapter 9 in *FORMAL LEGAL THEORY* (forthcoming 2003) (draft at 28, on file with author).

23. SUMMERS, *supra* note 5, at 4. The reader should be reminded that while the ideological, political, and philosophical beliefs that inspired the adoption of these formal principles in Western countries' legal systems are essentially substantive ideas, they were introduced in these legal systems as formal, abstract values, devoid of any specific policy (in the public policy sense) content. It is in this sense that Summers and this author refer to these principles as being formal in nature. See SUMMERS, *infra* notes 25–26.

24. In Summers' words, "the principles of the rule of law include only form-oriented content, whereas first-order laws have non-formal[,] policy content." *Id.*

25. For Summers (and for us), "individual principles of the rule of law generally have far wider scope of application than individual first order [i.e., substantive-based] rules . . ." *Id.* at 7.

26. *Id.*

27. *Id.*

of abstraction, and, thus, reflect those basic formal principles of the rule of law.

It is with such an eye to the influence of form in all legal phenomena that Summers defines legal form as “a systematic purposive arrangement” for a certain legal phenomenon.<sup>28</sup> Legal form’s overall guiding and “tying-together” properties allow it to irradiate the core values of the rule of law to the whole legal universe, affecting, in this process, individuals, government, society, institutions, statutes, and even ways of thinking about the law. To illustrate the operation of legal form throughout the legal system, Summers develops a typology of legal phenomena.<sup>29</sup>

## B. The Typology of Legal Form

Summers separates legal phenomena into species that reflect areas where the interaction between form and complex human activity have been most fecund in the law: institutional, preceptual, non-preceptual, methodological, and systemic legal phenomena.<sup>30</sup> Legal phenomena are thus the units of analysis of Summers’ legal theory of form.<sup>31</sup> Because of legal form’s dynamic impact in the legal system, it continually shapes the content of legal relationships in society. Summers’ formal theory captures this dynamism largely because of the holistic view it takes in seeing legal phenomena as not only the result of form (which would amount to form-determinism), but rather as the result of the interaction between formal and non-formal elements within phenomena of law,<sup>32</sup> including the legal system as a whole.<sup>33</sup>

## II. Ulysses’ Return to Ithaca and a Modern Dilemma

Though Ulysses is an individual, this Note posits that he can be viewed as representing society as a whole as he agonizes between choices that are differently attractive and mutually inconsistent in terms of the short- and long-term goals they present. Like Ulysses who was caught in the dilemma of listening to the beautiful song of the Sirens or returning home after a long period of war,<sup>34</sup> modern societies face the conflict between two mutually inconsistent goals: greater present consumption and sustained economic growth in the future. By exploring Ulysses’ plight during this pivotal moment, we can discern what was formal and what was substantive in Ulysses’ dilemma. After considering Ulysses’ plight, it will be possible to recreate and connect him with the larger social, political, legal, and institutional context of interest-rate decisions in modern democratic societies.

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28. ROBERT S. SUMMERS, *Forms for Legal Phenomena and Why They Matter*, Chapter 1 in *FORMAL LEGAL THEORY* (forthcoming 2003) (draft at 1, on file with author).

29. See *id.* at 3.

30. See SUMMERS, *supra* note 10, at 2.

31. See SUMMERS, *supra* note 28, at 1.

32. See Atienza, *supra* note 9, at ix.

33. See SUMMERS, *supra* note 10, at 2.

34. See generally 1 ODYSSEY, BOOK VI (A.T. Murray trans. 1919, reprinted in the Loeb Classical Library 1974).



This study of Ulysses' dilemma will also shed light into why the change from politically- to non-politically-based interest rate decision-making became necessary.<sup>35</sup>

#### A. Ulysses and Appropriate Form, or Why Ulysses Made it Home

In Book VI of the *Odyssey*, and at some point in his return home to Ithaca, the exquisite voices of the Sirens singing from an island not far from his ship's course captivated Ulysses.<sup>36</sup> At that point there was nothing to prevent him from listening to them while continuing his trip. However, he recognized that the power of these voices was such that if he steered the ship ever closer to the reefs where the Sirens were located, his ship would be wrecked and he would be unable to continue his journey.

In modern economic terms, Ulysses faced a problem of time inconsistency in his optimal plan.<sup>37</sup> His optimal plan was to listen to the Sirens and then continue his journey.<sup>38</sup> But this was time-inconsistent, because once he embarked on the plan of listening to the Sirens, he would not be able to implement and accomplish the latter part of the plan—returning home.<sup>39</sup> By contrast, a time-consistent optimal plan is one that would specify a sequence of actions, one for each moment in time, which enjoys the property that the individual will actually choose in each time period the action specified by the plan.<sup>40</sup> Thus, as time elapses, the individual having undertaken a previously planned action will still choose the next

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35. For a brilliant account and broader political-economic interpretation of this narrative, see ELSTER, *supra* note 13, at 88–174. See also JON ELSTER, *ULYSSES AND THE SIRENS: STUDIES IN RATIONALITY AND IRRATIONALITY* 37 (1979) (presenting and introducing the notion of self-binding as a solution to the problem of weakness of will).

36. See ODYSSEY, *supra* note 34, at 216–17.

37. See ELSTER, *supra* note 35, at 65–66.

38. See generally ODYSSEY, *supra* note 34.

39. In other words, the beautiful song of the Sirens had the effect of endogenously changing Ulysses' preferences as he sailed by, which was the change he deliberately set out to resist. See ELSTER, *supra* note 35, at 77–78.

40. Professor Elster formally enunciates "self-binding" as a series of steps:

(i) [t]o bind oneself is to carry out a certain decision at time  $t_1$  in order to increase the probability that one will carry out another decision at time  $t_2$ .

....

(ii) If the act at the earlier time has the effect of inducing a change in the set of options that will be available at the later time, then this does not count as binding oneself . . . .

....

(iii) The effect of carrying out the decision at  $t_1$  must be to set up some causal process in the external world . . . .

....

(iv) The resistance against carrying out the decision at  $t_1$  must be smaller than the resistance that would have opposed the carrying out of the decision at  $t_2$  had the decision at  $t_1$  not intervened.

....

(v) The act of binding oneself must be an act of commission, not of omission."

ELSTER, *supra* note 35, at 39–46. This distinction will later prove very useful to explain what Argentina did by deciding to abolish its central bank. See discussion *infra* subsection IV(B).

planned action as the best action rather than some other, and so on.<sup>41</sup> If such a time-consistent plan exists, all the individual has to do is follow the plan, or failing that, subject himself to unknown or less ascertainable circumstances. However, Ulysses' biggest problem when he encountered the Sirens was not that he had time-inconsistent goals—a matter of substance<sup>42</sup>—but that *he did not even have a plan* (a problem of lack of form).

1. *Ulysses' Challenge: Time-Inconsistency of Goals Due to a Lack of Binding Form*

Looking from a detached perspective, and seeing the effect that the Sirens had on Ulysses, one can clearly see that a time-inconsistency problem arose from the fact that as time passed, proximity to the Sirens was affecting Ulysses' preferences. His perception of what would constitute the best action or series of actions at one moment changed in the next as he deviated from what he had just decided to do.<sup>43</sup> But Ulysses had a saving insight: aware of what was happening to him, he decided he needed a plan of action. Significantly, he made this decision without yet knowing what the specific substantive content of such a plan would be.<sup>44</sup> At that point, coming up with a plan that made his then time-inconsistent goals compatible was solely a matter of "mechanism design," or the formal arrangement of priorities and roles yet unarticulated. In other words, that was the moment when Ulysses realized he needed a formal purposive arrangement that could help him solve the time-inconsistency of his goals.

Ulysses then elaborated an "optimal plan" in which he came up with the idea of denying himself his legitimate right to decide the ship's course at some point in the future. He instructed his men to tie him up to the mast and ignore any orders to do anything other than sail away from the reefs after some pre-established, planned point. To assure total compliance from his crew, Ulysses told them to plug their ears and row.<sup>45</sup>

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41. This is largely illustrative of step (iv) in Elster's formal definition of self-binding. See ELSTER, *supra* note 35, at 46.

42. Generally, economic analysis focuses on making choices within exogenously set constraints—time and financial resources being common constraints. See, e.g., Buchanan, *supra* note 12, at 2–3 ("In the elementary textbook formulation of demand theory, for example, the individual consumer-purchaser confronts a range of goods available at a set of prices, but is restricted by the size of the budget."). Choosing among a range of goods within a budget constraint clearly indicates that the nature of these choices is substantive, not formal. The formal approach developed in this Note looks beyond this model: "[W]e [constitutional political economists] observe that individuals do, in fact, choose their own constraints, at least to a degree and within some limits." *Id.* at 3.

43. That is, in Elster's terminology, Ulysses' preferences are endogenously changing. See ELSTER, *supra* note 35, at 77–78.

44. Elster poignantly illustrates this point, distinguishing between "the choice of an action and the choice of a way of choosing." See *id.* at 13. In Summers' terminology the first choice is a substantive matter, the second a formal one. See SUMMERS *supra* note 5, at 34; discussion accompanying Section I.

45. In Ulysses' words: "... but you must bind me hard and fast, so that I cannot stir from the spot where you will stand me . . . and if I beg you to release me, you must tighten and add to my bonds.' . . ." See, e.g., ELSTER, *supra* note 35, at 36 (quoting THE ODYSSEY).

## 2. *Ulysses' Mechanism Design: Submitting Oneself to Binding Rules*

Ulysses' plan was a set of binding rules that completely constrained his future choices. By using elements of his natural, social, and institutional environment, Ulysses managed to subvert certain destructive, yet irresistible inclinations of his near-future self. His preferences were endogenously changing with the closer proximity to the Sirens.<sup>46</sup>

Ulysses' plan is quite illustrative of the dilemma facing today's monetary authorities, namely the need to sacrifice greater short-term economic growth by raising interest rates in the present to curb inflationary pressures, so that price stability and stable growth can be attained in the future. His plan also casts light on another choice Western societies would make only centuries later: that of living under the rule of law rather than under the law of the ruler.<sup>47</sup>

### B. *Ulysses and Today's Democracies: Some Surprising Parallels*

Like certain societies of the future, Ulysses decided to bind himself to a form-oriented plan because that is the price one has to pay to restrict the conduct of others.<sup>48</sup> Choosing to limit the scope of choices at such a fundamental level allowed both Ulysses and, centuries later, Western societies, to make great advances on the road to freedom. Here as later, form countered the tendency for free agency to degenerate into chaos.

The tendency of democracies to degenerate toward chaos is illustrated by a familiar agonizing choice that government officials face in all modern societies: continue on an inflationary course and fuel each threatened downturn with new money and credit, or resolutely place limits upon the growth of the money supply via the sale of treasury bonds.<sup>49</sup> To follow the first course eventually threatens the stability of the social order,<sup>50</sup> but to take the second route has short-run ill effects in terms of high interest rates and greater unemployment.<sup>51</sup> In democracies, the second path also leads

46. See *id.* at 77-78.

47. For a most insightful account of the political-economic dynamics involved in this change, see, for example, Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567, 567-76 (1993).

48. Some argue that Ulysses' being tied to the mast is the figurative equivalent of adopting a constitution. See, e.g., ELSTER, *supra* note 13, at 94-95. Incidentally, and quite tellingly, the logo of the Constitutional Political Economy Journal is a drawing of Ulysses tied to the mast. See Buchanan, *supra* note 12, at 1.

49. Selling treasury bonds in the open market mops up money stored in bank reserves, which then increases interest rates. For a more detailed explanation, see *Monopoly Power over Money*, ECONOMIST, Nov. 20, 1995, at 95.

50. Indeed, the disintegration of German democracy that ended the Weimar Republic is largely blamed on the inflationary policies adopted during that period. See, e.g., ELSTER, *supra* note 13, at 164 (arguing that the German Bundesbank acquired its independence "as a response to the inflationary trauma of the 1920s"); but see *id.* at 164 n. 163 (citing E. Déhay, L'exemple allemand d'indépendance de la banque centrale (1998)). Déhay argues that the "legislation that established the independence of the Bundesbank is better explained as a compromise between the federal government and the governments of the Länder . . . than as an abdication by politicians who had learned not to trust themselves as guardians of monetary policy." *Id.*

51. See F. A. HAYEK, *INDIVIDUALISM AND ECONOMIC ORDER* (1948).

more quickly to the loss of government and legislative offices.<sup>52</sup>

Finally, by binding a group of actors to a pre-established formal arrangement where the scope of discretion is limited (and not tainted by what then appears as politically expedient), both Ulysses and Western democracies position themselves to solve the problem of time-inconsistency of their goals.<sup>53</sup> In carrying out their part of the plan, public officials, like Ulysses, ultimately contribute to the cause of democracy (through political and economic stability) and freedom.<sup>54</sup> Jhering perhaps put it best when he remarked that "Form is the sworn enemy of the arbitrary, the twin sister of freedom."<sup>55</sup> Drawing upon this insight, this Note now clarifies how appropriate legal form paves the way to political and economic stability and freedom.

### III. Cumulative Effects of Choices of Form

#### A. How Appropriate Form Contributes to Appropriate Content

As mentioned above, this Note focuses on Ulysses' plight not only to show the necessity and profound effects of form, but also to demonstrate how appropriate form contributes to appropriate content.<sup>56</sup> Accordingly, the

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52. Note that inflation does not merely encourage social and political conflict. Long inflationary periods produce short time horizons within the public (i.e., strong bias for present consumption coupled with heavy discounting of the utility of consumption in the future), making it ever less amenable to the necessary policy changes. However, the temptation of officials to buy short-run support with inflation is also self-defeating. The resulting rise in time preferences and the growing loss of value in cash holdings make the public ever more inclined to lose patience with officialdom. Indeed, a public historically accustomed to short time horizons demands satisfaction—and quickly. See generally ADAM PRZEWORSKI, *DEMOCRACY AND THE MARKET: POLITICAL AND ECONOMIC REFORMS IN EASTERN EUROPE AND LATIN AMERICA* (1991).

53. ELSTER, *supra* note 13, at 153 (asserting that: "[t]he creation of independent central banks illustrates the idea of separation of powers as a precommitment device to overcome time-inconsistency").

54. The Economist summed up this problem quite concisely:

Monetary policy affects the economy only after a long lag, so policymakers need a long time horizon. Short-sighted politicians might try to engineer a boom before an election, hoping that inflation would not rise until after the votes have been counted. An independent central bank shielded from political pressures is more likely to give priority to price stability; as a result its policies are seen by financial markets as more credible. An independent central bank can therefore deliver both lower inflation and more stable growth.

*Fiscal Flexibility: Could Finance Ministers Learn a Few Tricks from Central Bankers?*, *ECONOMIST*, Nov. 27, 1999, at 80.

55. RUDOLF VON JHERING, 2 *DER GEIST DES RÖMISCHEN RECHTS* 471 (1993).

56. Note that by stating that good form contributes to good content, I do not intend to imply that form alone is to receive credit here. There is no doubt that substantive knowledge derived from the development of the field of macroeconomics guides the interpretation of the hard economic data that today's central banks look into. But the fact that central bankers have such substantive knowledge is actually a matter of secondary importance. For instance, Venezuelan central bankers trained in the United States also share such knowledge, yet they cannot act according to their training. The crucial difference is that they are not operating within a formal institutional framework where they are independent of what political agents might want them to do. Form here, indeed, makes all the difference.

goal herein is to demonstrate the effect of form on content through an abbreviated analysis of the cumulative effects of choices of form on a specific problem: the elimination of politically-generated business cycles by the depoliticization of interest rate decisions in Western democracies.<sup>57</sup>

Following Summers' methodological scheme, the main stages of the linear progression that link the choice of a formal solution to its concrete manifestation as a legal phenomenon are:

- A. determination of the appropriate basic technique;
- B. selection of law-making participants;
- C. establishment of a legislative institution;
- D. creation of the primary statutory law by the legislature;
- E. promulgation and dissemination of the law, and education of primary addressees of the law as to the form and content of this law;
- F. application of the law by its addressees in ordinary cases;
- G. the role of administrative officials and the (unlikely) judicial disposition of disputes.<sup>58</sup>

Initially, choices of form are only bounded by the original formal purpose they are designed to serve—in this and in Ulysses' case, that of solving the conflict between two time-inconsistent goals. But each of the stages of the above linear progression requires making certain choices of form, and, generally, such choices will be both form-constrained (by previous choices of form) and form constraining (on subsequent choices of form).

## B. The Cumulative Effect of Choices of Form in Macroeconomic Policy

### 1. *Determination of the Appropriate Basic Operational Technique*

All basic forms of legal phenomena, be they institutional, preceptual, or non-preceptual, are implemented through one, or more, of five operational techniques: the grievance-remedial, the penal, the administrative-regulatory, the public-benefit conferral or the private-arranging technique.<sup>59</sup> For the problem this Note focuses on—that of solving the conflict between the mutually inconsistent goals of greater present consumption and greater economic growth in the future—Congress chose to use the administrative-regulatory technique.<sup>60</sup>

But why did Congress choose this technique? The forward-looking nature of any legislation designed to curb political management of interest rate policy for short-term electoral gain appears to be the most compelling

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57. This analysis is abbreviated because in presenting the progression involving the creation and implementation of a statutory rule in the administrative-regulatory technique, I chose not to explore the likely effects of such norms if the political entities involved (i.e., those responsible for designing a solution to the problem) had decided to use different operational techniques. Therefore, this Note will not elaborate on what would be the different formal consequences of the adoption of a different operational technique, such as the grievance-remedial, the penal, the public-benefit conferral or the private-arranging technique.

58. SUMMERS, *supra* note 16, at 3.

59. SUMMERS, *supra* note 10, at 36-38.

60. See Federal Reserve Act of 1966, 12 U.S.C. §§ 221-28 (2000); see also discussion *infra* subsection III(B)(3) and sources cited *infra* note 67.

reason why the administrative-regulatory technique was adopted in this area. The essential time-boundedness of monetary policy would preclude the adoption of any other technique as a means to achieve the goal of price stability. The grievance-remedial, and the penal techniques, which are past-event oriented, would be of little help here. For instance, the affected citizen himself could do very little through the grievance-remedial technique (other than casting a vote) to reverse the nefarious effects on his life of the onset of inflation that opportunistic interest rate decisions caused. One would imagine the potentially affected citizen might prefer to adopt a preventive strategy if he could.

The problem with that notion is that the “[affected citizen] will not even be able to identify the risks in advance . . . [and] even when the affected citizen does know something is wrong he may be unable, alone, to do anything about it in advance.”<sup>61</sup> Public choice literature, through the concepts of “free-riding” and “lack of encompassing interest,” has cast some light on why individuals are discouraged to act for the collective sake when their individual costs far exceed their potential individual benefits.<sup>62</sup>

Therefore, one can appreciate why modern Western democracies chose the administrative-regulatory technique as the basic operational technique to attack the problem at hand. In doing so, they chose the appropriate purposive systematic arrangement to deal with a particular problem, that is, they chose the appropriate *form* of operational technique.<sup>63</sup>

However, the eventual efficacy of this legal operational technique should not solely be credited to the choice of appropriate form. While no other basic operational technique would be likely to produce the fantastic results the chosen technique brought about, it seems quite unlikely that the administrative-regulatory technique alone, without relying on the set of non-formal elements then available in the West, would produce similar results. These non-formal elements are: the content of the rules that prescribe choices of policy grounded on sophisticated substantive and quantitative economic analyses; the high level of expertise of the personnel who make up central banks; the high sophistication of today’s communicative devices; the perhaps even more highly sophisticated financial markets, and many more.<sup>64</sup> In monetary policy, perhaps more than in any other policy area, choosing a form that is least likely to fall victim to short-term electoral opportunism, whatever its political (substantive) origin, has generally been identified with long-term downward trends in interest rates. The market’s approval or repudiation tends to be immediate,<sup>65</sup> and the growing

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61. ROBERT S. SUMMERS & CHARLES G. HOWARD, *LAW: ITS NATURE, FUNCTIONS, AND LIMITS* 199-200 (2d ed. 1972).

62. See generally MANCUR OLSON, JR., *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965); MANCUR OLSON, JR., *THE RISE AND DECLINE OF NATIONS* (1982).

63. See SUMMERS, *supra* note 28.

64. See *Fiscal Flexibility: Could Finance Ministers Learn a Few Tricks from Central Bankers?*, *supra* note 54, at 80.

65. Note that markets perceive an independent central bank’s commitment to price stability as its source of credibility. See *id.*

prosperity of the West owes much to the choice of appropriate form.

## 2. *The Compounding Nature of Choices of Form in Macroeconomic Policy*

As demonstrated above, Congress's choosing the administrative-regulatory technique is itself an example of form-constrained choice. In essence, Congress's need to solve the problem of time-inconsistent goals demanded the design of a largely formal mechanism and solution that was formal in nature, and these needs largely determined the formal operational technique to be chosen. Furthermore, the choice of this technique is also a form-constraining choice, for it affects formal decisions, which have to be made further down the line, such as, who gets to participate in law-making, which legislative institution is qualified to prepare and draft the law, under what procedures, and under what circumstances the law is to be enacted, how it will be disseminated to its primary addressees, and so forth.

But perhaps more importantly, as we observed in the choice of the administrative-regulatory technique as the basic formal operational technique, all these choices of form will greatly affect the content of what is produced.<sup>66</sup>

Choosing the administrative-regulatory technique determines the institutional, the preceptual, the methodological forms, and the non-formal resources that will necessarily have to be brought to bear in order to prepare, enact and implement laws and regulations in this policy area, whatever their substantive content. By providing for the involvement of at least one regulatory agency (i.e., the central bank), this particular technique necessarily requires the granting of specific authority, normally discharged by means of a statute, which in turn, requires a preexisting legislative body. These are all choices of form.

Implementation of an interest rate policy (whatever its content) by a government agency will require a nationwide scope of authority. In the United States, this amounts to limiting the choice of institutional form to one single legislative body—Congress. That institution, in turn, has its own compositional, procedural, and structural forms (committee system, and other ancillary institutions, such as the General Accounting Office), and these forms themselves interact with non-formal elements such as political parties, lobbyists, advocacy groups, personnel, facilities—all affected by the initial choice of legal form and clearly willing to affect the form and content of the legislative outcome. Thus one would expect the different layers of form and the interaction of these forms with non-formal elements throughout this long process to have a strong and salutary imprint on the final policy content of the proposed law.

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66. This is surely in line with Summers' insight that good form begets good content: It is possible for those who govern to adhere to the principles of the rule of law, yet for the content of the first-order [i.e., substantive] law they create and implement be bad or unsound. . . . adherence to most of the principles of the rule of law, themselves form-oriented in content, generally tends to beget good policy content in the law being made.

SUMMERS, *supra* note 20, at 34.

### 3. *Application of the Law by its Addressees in Ordinary Cases and the Implementative Role of Administrative Officials*

One would expect Congress to elaborate a statutory scheme (preceptual form) for the administrative agency that both delegates and establishes limits on the authority to set interest rates.<sup>67</sup> Because of the clearly forward-looking nature of interest rate policy, and because of the difference in levels of expertise of the principal (Congress) relative to that of its agent (the Federal Open Market Committee (FOMC))<sup>68</sup>, the language of the statute (i.e., its encapsulatory and expressional form) is likely to be broad, with the occasional use of technical terms. Once again, we can see how the initial choice of form affects final legislative content.

A statutory rule of the type indicated above is more than the source of authority for the administrative agency.<sup>69</sup> It also provides that agency with a clear legal basis for action.<sup>70</sup> Therefore, for a member of the board of governors of the Federal Reserve, its final addressee, this rule would generally be internalized as follows: if you believe, on the basis of economic data available, that inflationary pressures are emerging in the economy, then you should vote for a present increase in the rate of interest to a level that is targeted to offset the likely impact of the inflationary pressure expected to occur. The converse movement applies if deflationary or recession pressures are forecasted.

This is obviously a simplified version of the combined operation of federal statutes, and its ancillary regulations in this area.<sup>71</sup> But what is important, as we explain this complex chain of reasoning, is that the stat-

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67. Congress did so in the Federal Reserve Act of 1966, 12 U.S.C. §§ 221 et seq. (2000). Section 263(a) establishes the FOMC, "which shall consist of the members of the Board of Governors of the Federal Reserve System and five other representatives of the Federal Reserve banks. . . ." *Id.* at § 263(a). It also gives the FOMC the power to take measures to affect the supply of money. *Id.* at §§ 263(b) & (c). Interestingly, the District of Columbia Circuit upheld Congress' authority to delegate to private persons the power to affect the supply of money, by allowing the board of directors of the Federal Reserve banks, rather than the President, to choose such private persons, pending confirmation by the Senate. *Melcher v. Fed. Open Mkt. Comm.*, 836 F.2d 561 (D.C. Cir. 1987). The *Melcher* court held that where "a legislator could obtain substantial relief from his fellow legislators through the legislative process itself, then it is an abuse of discretion for a court to entertain [the legislator's] action." *Id.* at 565. The practical consequence of this decision is that, to date, there has been no successful challenge to the FOMC's power to independently set interest rates.

68. 12 U.S.C. § 263 (2000).

69. See GELHORN & BYSE, *ADMINISTRATIVE LAW* 192-93 (9th ed. 1995).

70. *Id.*

71. Actually, in the United States, as in other Western countries, the Federal Reserve ("the Fed"), or the central bank, affects interest rates by a rather roundabout procedure: "The reason the Fed can set interest rates is that it has a monopoly on supplying bank reserves. Banks are required to hold a fraction of the money deposited with them in a reserve account at the Fed . . ." *Monopoly Power over Money*, *ECONOMIST*, Nov. 20, 1999, at 95. The federal funds rate is the "interest rate at which banks' demand for reserves matches the Fed's supply . . . [and] is also the rate at which banks lend reserves to each other overnight." *Id.* To understand how the Fed works, it is important to remember that the banks' legal requirement to keep reserves in the central bank necessarily causes the demand for reserves to exceed supply of those reserves at all times:



ute is perfectly suited to its final addressee, and that it has achieved its intended result. It truly is amazing how previous choices of appropriate form greatly facilitate the addressee's capacity to not only determine the meaning of the rule, but to classify "factual circumstances as falling under the terms of the rule"<sup>72</sup> and act accordingly.

### C. Consequences of Appropriate Legal Form

The set of formal choices responsible for the removal of interest rate decisions from the political process in Western societies appears to be a function of the maturity of their political systems. However, the greater economic vitality of the West,<sup>73</sup> which this quiet revolution has helped to bring, is certainly not its only success story. Perhaps it is not even its biggest achievement. The furthering of values associated with democracy, the rule of law, and rationality are the greatest beneficiaries of appropriate form.

Substantively, the choice of appropriate form in the conduct of macroeconomic policy has introduced a definite element of fiscal austerity in politics. Indeed, to the extent that central bank autonomy increases the costs of generating short-term expansionary cycles, politicians are forced to operate within monetary as well as fiscal constraints.<sup>74</sup> While politicians do disagree on how to allocate resources, they no longer can or are willing to advocate economic programs that in the past have been closely associated with inflationary periods. Democracy has thus been strengthened as economic-based sources of political instability have become less likely and, more importantly, because compliance with formal rules has become automatic with little need for judicial intervention.<sup>75</sup> This development illustrates not only the high level of self-compliance achieved—a

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The Fed controls [the federal funds rate] by changing the supply of reserves through sales and purchases of government securities, known as open-market operations . . . .

. . . .

When the Fed wants to raise the federal funds rate [and hence increase short-term interest rates], it sells government securities. It receives payment by reducing the account of the buyer's bank, which reduces the volume of reserves in the banking system . . . .

*Id.* Thus, banks must make new reserve deposits in order to comply with legal requirements. *Id.* However, to lower rates, the Fed buys back securities, "which increases banks' reserves and bids down interest rates." *Id.* Thus, to be accurate, while it is true that the members of the FOMC do not directly decide what interest rate increase or decrease to adopt, their decision to sell or buy government securities is what actually causes the resulting effect on short-term interest rates. *See id.*

72. SUMMERS, *supra* note 16, at 24.

73. In the late 1990s the "average inflation rate in the rich economies" was slightly above 1%, with falling levels of unemployment. *See Navigators in Troubled Waters*, *supra* note 15, at 3.

74. *See Alesina & Summers, supra* note 2, at 151-62.

75. Not surprisingly, Alan Blinder, an economist at Princeton University and a former vice-chairman of the Board of Governors of America's Federal Reserve, has argued that the institutional framework around monetary policy should be extended to fiscal policy. *See Alan S. Blinder, Is Government too Political?*, *FOREIGN AFF.*, NOV.-DEC. 1997, at 115-26.

result which enforces the rule of law—but also how the addressees of such formal choices have understood the complex and mutually reinforcing relationship between form and freedom—giving further strength to the argument that appropriate form serves rationality.<sup>76</sup>

#### IV. Consequences of Inappropriate Legal Form: The Case of Argentina

As discussed throughout this Note, the ubiquity of interest rates and the potential for their manipulation for electoral purposes combine to make monetary policy an area in which politicians are usually hesitant to surrender control.<sup>77</sup> Indeed, in Western nations, the democratic process only moved towards granting independence to central banks after either long bouts with runaway inflation, economic instability, or political collapse.<sup>78</sup> Eventually, however, well-connected economic concerns, the wider, though not often well-articulated, “middle-class” stake in economic stability, and the maturity of Western democratic institutions contributed to this evolutionary development.<sup>79</sup>

This does not imply that societies lacking mature democratic institutions, which nonetheless wish to part with a history of high inflation, cannot come up with formal solutions to the problems of politically oriented monetary decision-making.<sup>80</sup> The question is whether appropriate form, capable of yielding good content, can emerge. In other words, like in Ulysses’ ship and in Western democracies, can less mature democracies develop self-binding rules such as central bank independence? The answer appears to be in the affirmative.<sup>81</sup> Consider, for example, events in Argen-

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76. Rationality is one of the fundamental political values—the others being “legitimacy, justice, freedom, dignity, and democracy”—that Summers suggests as being served by adherence to the formal principles of the rule of law. SUMMERS, *supra* note 20, at 33. Curiously, Kenneth Shepsle, one of the paramount scholars interested in state reform, emphasizes the crucial importance of rationality in public policy. KENNETH A. SHEPSLE, *THE POLITICAL ECONOMY OF STATE REFORM - POLITICAL TO THE CORE 1-20* (Inst. For Soc. Research: The Political Econ. Working Papers Archive, Working Paper No. 19980001, 1998), at [http://www.isr.umich.edu/cps/pewpa/archive/archive\\_98/19980001.pdf](http://www.isr.umich.edu/cps/pewpa/archive/archive_98/19980001.pdf). The difference between this view of rationality and mine, though not necessarily incompatible, is that Shepsle, like other substance-oriented scholars, tends to think of rationality largely in terms of achieving optimal economic goals, while Summers and this author think of rationality as also serving democratic and rule of law values. *See id.*

77. *See* ALESINA & TABELLINI, *supra* note 2; Alesina & Sachs, *supra* note 2; Alesina & Summers, *supra* note 2.

78. *See* ELSTER *supra* note 13, at 162–65.

79. For example, *The Economist* noted that “it is now widely accepted that monetary policy is best set by an independent central bank, insulated from political pressures.” *Navigators in Troubled Waters*, *supra* note 15.

80. Some scholars focus on the use of a different kind of formal legal arrangement as a tool to combat inflation: devolving power or decentralization. *See, e.g.,* DANIEL TREISMANN, *DECENTRALIZATION AND INFLATION IN DEVELOPED AND DEVELOPING COUNTRIES* (Institute for Social Research: The Political Economy Working Papers Archive, Working Paper No. 19980016, 1998), at [http://www.isr.umich.edu/cps/pewpa/archive/archive\\_98/19980016.pdf](http://www.isr.umich.edu/cps/pewpa/archive/archive_98/19980016.pdf).

81. The Czech Republic, for instance, conferred independence on its central bank in its constitution. ELSTER, *supra* note 13, at 150.

tina. Faced with the total loss of credibility from decades of runaway inflation, which culminated in the early resignation of President Raúl Alfonsín, the Menen administration, after some initial, less drastic reforms, introduced a currency board in 1991.<sup>82</sup> Argentina's creation of a currency board offers strong evidence that less mature democracies can engage in monetary self-binding.<sup>83</sup> Thus, the relevant question becomes whether Argentina's strict currency board constituted appropriate legal form.<sup>84</sup>

A. Surrendering the Sovereign Right to Conduct Macroeconomic Policy: Argentina's Resort to a Strict Currency Board as a Case of Inappropriate Form

Unlike a conventional central bank which can print money at will, a currency board issues domestic notes and coins only when there are foreign exchange reserves to back them up.<sup>85</sup> Under such a system, interest rates will adjust automatically, that is, independently of monetary authority action. This is so because when investors want to switch out of the domestic currency into, say dollars, the supply of domestic currency will automatically shrink. This will cause interest rates to rise, until eventually it becomes attractive for investors, both foreign and local, to hold local cur-

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82. A currency board is the title given to the commitment of a government to convert its domestic currency on demand at a fixed exchange rate. To make this commitment credible, the currency board holds reserves of hard foreign currency (or gold or some other liquid asset) equal at the fixed rate of exchange to at least 100% of the domestic currency issued. From 1991 to the final days of 2001 the Argentine Peso, for instance, had been convertible into one American dollar. For a comparative discussion on currency boards, see generally D. Mihalke, *Currency Board Arrangements: Issues and Experiences*, IMF OCCASIONAL PAPER 151, Sept. 1997.

83. Other examples of monetary policy self-binding are Mexico's (1993) and Brazil's (1999) combination of floating currencies with fixed inflationary targets that have made significant, though not yet complete, advances toward central bank independence. See, e.g., *Floating with an Anchor: The Latest Exchange-Rate Fad in Emerging Economies is for Flexible Currencies, but Fixed Inflation Targets. Will it last?*, *ECONOMIST*, Jan. 29, 2000, at 88 [hereinafter *Floating with an Anchor*]. The Chilean experience with central bank autonomy also illustrates that young democracies can coexist with monetary policy self-binding. *Id.* Note, however, that it was the Pinochet regime that had first approved measures establishing an independent central bank in 1989. See Delia M. Boylan, *Holding Democracy Hostage: Central Bank Autonomy in the Transition from Authoritarian Rule* (1998), at [http://www.harrisschool.uchicago.edu/pdf/wp\\_boylan.pdf](http://www.harrisschool.uchicago.edu/pdf/wp_boylan.pdf). Other than the surrender of power, this was perhaps the previous authoritarian regime's best contribution to Chile's present stable democracy. For a contrary opinion, see Delia M. Boylan, *id.* (arguing that giving the Chilean Central Bank autonomy was a means for the exiting regime to constrain incoming democratic institutions to "neoliberal" policies).

84. See SUMMERS, *supra* note 10, at 39-44; discussion *supra* INTRODUCTION.

85. *The Great Escape: How do you say Goodbye to a Currency Board? The More Stable the Economy, the Easier the Answer*, *ECONOMIST*, May 3, 1997, at 69 [hereinafter *The Great Escape*]. This article is especially ominous; it discusses how hard it would be for the then-troubled Lithuania to gradually remove itself from its currency peg as Lithuania was then running a budget deficit in the order of 2.5% GDP. *Id.* This reasoning, however did not apply to Argentina at the time it was written, as its budget deficits were only starting to resurface. See also *Dollar Mad?*, *supra* note 17, at 72 (pointing out Argentina's fiscal laxity resurgence after the first five years of fiscal austerity under the dollar-peg).

rency again.<sup>86</sup> This obviously amounts to a complete abdication of a country's sovereign right to set its own interest rate. But to the Argentinean government in 1991, a monetary policy straight jacket was seen as the only alternative to its long perceived lack of credibility.

In formal legal theory terminology, Argentina opted for the near-perfect predictability and the strictly rule-based nature of a currency board to limit the influence of politics on interest rate policy. The choice of the administrative-regulatory as the basic operational technique, though similar in principle to the technique adopted in Western democracies, left absolutely no room for central bank discretion. From the moment of the currency board's implementation, interest rate movements were determined solely by market forces, that is, by how the market perceived the evolution of Argentina's fiscal austerity.<sup>87</sup> The only thing the currency board would do was assure it had reserves to back up the peso. Unlike the more mature democracies of the West, the administration saw no point in relying on central bank independence at a time when the government's stock of credibility was so low. And unlike Ulysses, the Argentinean government did not consider retaking control of the monetary policy ship, once short-term turbulence had been overcome. Concern with substantive, short-term economic goals, not with creating a lasting institutional design (i.e., a formal concern) drove Argentina's plan of action.

The Argentine government believed that sacrificing the ability to make monetary policy *in toto* was the price to pay for establishing credibility. But what was actually disturbing is that it (perhaps fearing the market perception of lack of resolve) did not at all bother to formulate an exit strategy for the long-run, that is, for when it would have managed to reestablish credibility and economic stability.<sup>88</sup> Rather, unfazed by the inability to use interest rates as a macroeconomic tool to counter economic cycles in the short, medium and long-term, the Argentinean government passed, with the approval of Congress, legislation setting the currency board in stone as its preferred legal form of self-discipline for many years to come, with no provision for an escape strategy.<sup>89</sup>

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86. Note that when the opposite happens, that is, when there is an inflow of foreign investment, the resulting increase in the board's vaults will require it to print more money, thereby making the country more vulnerable to inflation. See, e.g., *The Great Escape*, *supra* note 85.

87. To be more precise, the adoption of a currency board comes necessarily with the abolishment of a central bank. See generally PAUL R. KRUGMAN & MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS: THEORY AND POLICY* (5th ed. 2000).

88. Note that a good indicator of appropriate legal form, according to Summers, is that "so far as feasible, . . . new written law is generally to be prospective rather than retrospective in operation . . ." SUMMERS, *supra* note 22, at 28.

89. In a recent *post mortem* editorial on Argentina, Princeton's famous economist, Paul Krugman, strongly criticized Argentina's unfortunate commitment to a no-exit strategy for its currency board regime. Paul Krugman, *Crying with Argentina*, N.Y. TIMES, Jan. 1, 2002, at A21. Krugman credits the IMF for this mistaken policy:

I.M.F. staffers have known for months, perhaps years, that the one-peso-one-dollar policy could not be sustained. And the I.M.F. could have offered Argentina guidance on how to escape from its monetary trap, as well as political cover for Argentina's leaders as they did what had to be done. Instead, however, I.M.F.

Thus, the dollar-peg, or as the Argentineans termed it, the policy of "convertibility,"<sup>90</sup> in combination with the lack of an adjustment/exit strategy turned out to be the preceptual form of choice. That formal arrangement later proved to be the cause of much of Argentina's economic woes.

However, currency boards as a legal form of self-discipline or self-binding do have some advantages.<sup>91</sup> For example, they tend to be successful in keeping inflation at low levels because the discipline upon which they are premised helps to limit unnecessary government spending.<sup>92</sup> Indeed, "in the five years after the introduction of the currency board, Argentina pruned spending and subsidies dramatically."<sup>93</sup>

But the lack of an exit strategy despite its initial successes, shows how formally inappropriate the Argentinean currency board regime turned out to be. Alas, the stability that resulted from the government's inability to print money, and the ensuing recovery of credibility were not used as an opportunity to gradually move from total surrender of monetary policy towards a mixture of foreign currency and domestic government bonds. Indeed, such a move would have opened the way for eventual counter-cyclical central bank action that could help steer the country through economic fluctuations, such as commodity prices and other external shocks.

Yet, the absence of a plan to gradually bestow discretion and, eventually, independence to the central bank (a step that we know the West did take), apparently done in the name of restoring credibility, would actually end up undermining it. A strict currency board, with no foreseeable possibility of relaxation, left Argentinean politicians free to profit from the country's regained credibility in a most perverse way. After the fifth year of fiscal discipline, the government began engaging in excessive borrowing from abroad as it slowly reverted back to policies of the past. It began running budget deficits. Political control of the budgetary process even under a strict currency board proved too tempting. In addition, an immobilized (actually inexistent) central bank was not there to shut down the party by acting independently of short-term oriented electoral horizons.

From a political-logistic standpoint, it is true that initiating a gradual transition from a strict currency board to a mixed regime around 1996

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officials—like medieval doctors who insisted on bleeding their patients, and repeated the procedure when the bleeding made them sicker—prescribed austerity and still more austerity, right to the end.

*Id.* While this author agrees that the IMF erroneously supported the overextension of this policy, the blame ultimately rests with the Argentinean government's insistence on its policy, for the hard-earned credibility of the first five years of the dollar parity provided them the cover to the return to fiscal laxity and excessive borrowing that later proved to be fatal. See *Dollar Mad?*, *supra* note 17, at 72.

90. *The End: Domingo Cavallo's Refusal to Face Realities is Digging Argentina into an Ever-Deeper Hole*, *ECONOMIST*, Dec. 8, 2001, at 12 [hereinafter *The End*].

91. The late Rudiger Dornbusch of MIT published an article defending the advantages of currency boards despite Argentina's policy failure. See Rudiger Dornbusch, *Exchange Rates and the Choice of Monetary-Policy Regimes: Fewer Monies, Better Monies*, 91 *AMER. ECON. REV.* 203 (2001).

92. See *Dollar Mad?*, *supra* note 17, at 72.

93. *Id.*

would have taken some legislative undoing. It would have necessarily required enactment of new laws repealing the then-legislated currency board, which was a tight knot to untie. However, the timing in the mid-nineties could not have been better for such action. Domestic and foreign investors would not have condemned a gradual move away from the strict currency board regime to a more flexible currency board if the Argentinean government took measures to ensure the markets that it would not tinker with the fiscal discipline that had restored credibility.

Other than the lack of an exit strategy, which is not a necessary fixture of currency boards,<sup>94</sup> but which proved to be fatal in the case of Argentina, dollar-pegs themselves have some serious drawbacks. First, under a currency peg, a government ceases to be able to use the exchange rate to help the economy adjust to outside shocks, such as a fall in export prices or sharp shifts in capital flows. Instead, domestic wages and prices must adjust.<sup>95</sup> Second, a currency board can also put pressure on banks and other financial institutions if interest rates rise sharply as investors dump the local currency.<sup>96</sup> Third, a conventional central bank can curtail a potential banking panic by lending money freely to banks that are feeling the pinch.<sup>97</sup>

What the Argentine government did not publicly say is that if economic and financial fundamentals deteriorated, investors and checking account holders would no longer regard the system as automatic, but rather, they would watch the government's actions and at the slightest sign of weakness, they could withdraw in mass, anticipating a devaluation—or worse, a default—thus causing the entire system to crumble. Such crumbling characterizes the long agony that Argentina suffered until the currency board was scrapped in the early days of 2002, after the resignation of four presidents in three weeks amid political and economic chaos.<sup>98</sup>

One might wonder why Argentina's formal approach to credible economic policy via monetary policy abdication did not work when it involved self-binding on the part of government. Was it bad substantive economic policy, or rather, was it more a matter of bad form, which in turn begat bad content? Of these possibilities, the latter seems to be the most illuminating. It suggests an answer that not only accounts for the bad policies that followed the original decision to implement the peg without an exit strategy, but, more importantly, it implies that a full answer can only be given if we account for the role that bad legal form played in Argentina's economic policy and eventual political collapse.

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94. Prior to Argentina, Singapore and Malaysia successfully abandoned their currency board regimes by floating their currencies. *The Great Escape*, *supra* note 85. This worked because, unlike Argentina, they "had stable economic policies, and strong capital inflows from abroad." *Id.*

95. In a country, such as Argentina, where prices are sticky, the risk of currencies becoming overvalued is high, and exports certainly suffer, thus causing balance of payment problems.

96. See *Dollar Mad?*, *supra* note 17, at 72.

97. See *id.*

98. See Krugman, *supra* note 89, at A21.

## B. Ulysses and the Sirens Revisited

To show how abdication of monetary policy as a method of self-binding can, and, in the case of Argentina, did turn out to be a mistake, we again turn to the Ulysses analogy. Aiming to cure the time-inconsistency problem inherent in his preferences, we remember that Ulysses exploited elements of his natural and social environment, crafted binding rules, and thereby was able to subvert certain inclinations that he knew would be destructive to his overall interests but which would nonetheless prove irresistible when they arose.<sup>99</sup>

Like the Argentine government centuries later, Ulysses not only had his crew tie him high on his ship's mast, the metaphorical equivalent to surrendering political control of monetary policy, but he also told his subordinates that after some point they should plug their ears and row towards their final destination.<sup>100</sup> In these final orders we perceive two crucial differences between the Homeric account and Argentina's approach to self-binding rules.

The first distinction between Ulysses and Argentina's plan is that while Ulysses surrendered control of the ship for a moment, he left his ship under the control of his crew, which, following his precommitment orders, not only rowed but steered his ship to safer waters.<sup>101</sup> The Argentine government, on the other hand, chose to bind itself by extricating itself from any possibility of formulating monetary policy in the future. Unlike Argentina's self-binding model, Ulysses' surrender of his ship's control never amounted to an order of such passive abandonment that would allow the waves and currents to set his ship's course. That is, Ulysses' agents executed his formal plan having discretion to dictate how hard to row and how to steer as the ship interacted with the forces of the sea. What the Argentine government did was dramatically different: it surrendered more than political control over the interest rate. It surrendered state sovereignty completely by leaving no room for central bankers to exercise any discretion whatsoever.<sup>102</sup> It tied their hands indefinitely by abolishing the central bank altogether.

This kind of self-binding constituted bad form because it left an entire country's economy at the mercy of forces it could no longer control. Exposure to external shocks, such as the Brazilian devaluation of the *real* in

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99. See discussion *supra* subsection II(B).

100. *Id.*

101. *Id.*

102. In a very strict sense, Argentina did not fully satisfy Elster's definition of self-binding because it violated condition (v) of Elster's definition which requires "the act of binding oneself [to] be an act of commission, not of omission." See ELSTER, *supra* note 35, at 46. By deciding to abolish its central bank, with no end in sight, Argentina opted for omission in monetary policy. The government and the then-defunct central bank could no longer "commit" to any monetary action. This imperfection, however, should not displace what Argentina did as self-binding in a broader sense. Indeed, as I suggest below, what Argentina did can be seen as a case of self-binding in the extreme, and inappropriate legal form.

early 1999,<sup>103</sup> could no longer be adjusted by monetary policy.<sup>104</sup> Worse yet, this type of self-binding did not eliminate the root cause of Argentina's earlier history of inflation and its later self-abandonment to persistent economic fragility and the government's return to fiscal deficits.<sup>105</sup> Rather, the false impression of stability, given by the parity with the dollar, did not hide from sophisticated foreign investors the persistent underlying source of weakness in Argentina's economy—the constant need for foreign financing. Indeed, the very legal design that forewent monetary policy earlier, allowed the government to continue running fiscal deficits. The only practical difference between Argentina's hyperinflation and currency peg days was that the government was no longer financing its debt by printing money; it was now financing its deficits with foreign financing, backed by a currency peg.<sup>106</sup> Thus, unlike its Homeric counterpart, the Argentine government not only allowed itself to be tied, but also “threw away the key,” by leaving its central bank impotent to respond to the events that would come.

The second major difference between the Argentine experiment with self-binding and that of Ulysses has to do with what happened after calm was restored. After the ship had sailed well beyond the dangerous waters surrounding the captivating Sirens, Ulysses retook control of the ship. Things were different when credibility was finally restored in Argentina. The Argentinean government did not take steps to gradually reestablish monetary sovereignty. Rather, it preferred to revert to its old short-term oriented political inclinations, wasting away Argentina's hard fought credibility by engaging in excessive borrowing and budgetary indiscipline.<sup>107</sup>

In modern Western democracies, politicians would not have enjoyed such freedom for long. At the slightest sign of inflation, independent central bankers would have gradually increased short-term interest rates in anticipation of the inflationary effects of such policies (long-term rates would increase too), thereby dooming the politicians' short-term electoral plans.<sup>108</sup>

In sum, Argentina's chance to establish an enduring strategy was squandered under the very guise of short-term fiscal discipline when politicians generated budget deficits without being themselves subject to monetary policy checks.<sup>109</sup> In the absence of an autonomous central bank with discretion to increase the costs of generating short-term expansionary cycles to politicians,<sup>110</sup> the Argentinean drastic policy of surrendering its sovereign right to conduct its own monetary policy impeded the govern-

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103. See, e.g., *Floating with an Anchor*, *supra* note 83, at 88.

104. Indeed, as “Argentina's main trading partners devalued . . . the economy sank into a recession that shows no sign of ending, and has made the debt unpayable.” *The End*, *supra* note 90, at 12.

105. The government started piling up deficits around 1997. See *id.*

106. See *The Great Escape*, *supra* note 85, at 69.

107. *The End*, *supra* note 90, at 12.

108. See *Fiscal Flexibility: Could Finance Ministers Learn a Few Tricks from Central Bankers?*, *supra* note 54, at 80.

109. See *The End*, *supra* note 90; discussion *supra* subsection IV(B).

110. See Alesina & Summers, *supra* note 2; discussion *supra* subsection III(C).



ment from resorting to monetary policy tools that could help it respond to external economic shocks and to a deteriorating budgetary picture.<sup>111</sup> In the end, the lack of an exit strategy proved to be Argentina's undoing.<sup>112</sup> This result arose because the legal form that the Argentinean authorities chose to bind themselves—the currency board—did not include a prospective framework that provided for an exit strategy after credibility had been restored and inflation brought under control. In Summers' terminology, Argentina's legal approach to self-binding had a flawed prospective form.<sup>113</sup>

### C. Some Lessons for Argentina from Form-Oriented Legal Analysis

Summers' insight that bad form begets bad content<sup>114</sup> is borne by the dramatic economic and political events in Argentina during late 2001 and early 2002.<sup>115</sup> Argentina's persistent inability to adjust to foreign and domestic shocks<sup>116</sup> led to a succession of bad economic patch-up policies,<sup>117</sup> and resulting economic collapse.<sup>118</sup> In Argentina's long succession of unfortunate economic decisions, the budget cuts of June 2001, which involved among other drastic measures a cut in the nominal wages of public servants, proved to be the beginning of the end. Political turmoil and the growing threat of debt default, did much to undermine Argentina's insistence on the peg.

Bad form served an additional nefarious purpose. While restoring long-lost credibility, a currency peg devoid of an exit strategy mediated by a resurging independent central bank allowed the Argentinean political elite to hide its fiscal irresponsibility under the guise of austerity.<sup>119</sup> Thus, the currency peg hid from the public view evidence that the source of the Argentinean economic misfortunes continued to be the political class and their budgetary demands,<sup>120</sup> and not necessarily the IMF<sup>121</sup> or the U.S.'s

111. See *Dollar Mad?*, *supra* note 17, at 72; *The Great Escape*, *supra* note 85.

112. See *Dollar Mad?*, *supra* note 17; discussion *supra* subsection IV(B).

113. See SUMMERS, *supra* note 20, at 28.

114. See SUMMERS, *supra* note 10, at 34-35.

115. See *Argentina's Devaluation: From Straightjacket to Padded Cell*, *ECONOMIST*, Jan. 12, 2002, at 13.

116. See D. Mihalke, *supra* note 82; discussion *supra* Section IV.

117. In one of a long series of "austerity plans," in the winter of 2001, the Argentine government performed cuts of up to 13% in state pensions and salaries in an attempt to balance the budget. See *Argentina's Economy: The Austerity Diet*, *ECONOMIST*, Aug. 25, 2001, at 31. Curiously, one would expect currency boards to achieve balanced budgets by themselves.

118. In January 2002, Argentina at last gave up its decade-old policy of rigidly pegging its peso at one-to-one to the dollar; a confusing dual exchange rate system took its place. See *Argentina's Devaluation: From Straightjacket to Padded Cell*, *supra* note 115, at 13. For exports, some imports, and most capital transactions the peso was officially pegged at 1.4 to the dollar and for all other transactions the currency was allowed to float. *Id.* This dual system was supposed to last four or five months, after which the peso would be fully floating. *Id.*

119. See *The End*, *supra* note 90 (describing how the Argentine government engaged in excessive borrowing); discussion *supra* subsection IV(B).

120. Indeed, free-market skeptics, like President Duhalde himself, would like to steer Argentina away from pro-market policies and toward more old-style Peronist policies.

hands-off approach to Argentina's economic policy debacle.<sup>122</sup> In the end, rationality, predictability, and accountability were not served.<sup>123</sup> The Argentinean society's will to sacrifice for the principle of a strong currency broke under the pressures of prolonged recession and economic chaos.

### Conclusion and Policy Recommendations

This Note has illustrated the extent to which appropriate form can contribute to democracy, the rule of law, and the goals of rationality and predictability in legislation. In fact, while appropriate form helped Western societies successfully check political opportunism in the determination of interest rates, it also helped them reaffirm the importance of economic and political freedom. Bad form, on the other hand, as the above discussion of the Argentinean case shows, can seriously compromise these values.

These instances of monetary self-binding illustrate how appropriate form can be, in the words of Jhering, "the sworn enemy of the arbitrary, the twin sister of freedom."<sup>124</sup> The final credit for the choice of appropriate form in the monetary policy arena should go to the mature democracies of the West. Indeed, for so far only they have been able to engineer an institutional design that prevents the polity from being overwhelmed by the opportunistic pursuit of short-term political gains.<sup>125</sup>

As Jhering asserts, "[a] people that really understands the value of freedom has *instinctively* realized the value of the forms it possesses and maintains, not simply as something external, but as the very *palladium* of its liberty."<sup>126</sup> Western democracies have shown that the challenge for less mature democracies of Latin America and elsewhere is to divert democracy from its tendency to distort public policy from long- to mere short-term electoral goals. This means that institutional arrangements that pin "short-horizon politicians" to longer-horizon collective goals become fundamen-

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See Larry Rohter, *Argentina's Crisis: It's Not Just Money*, N.Y. TIMES, Jan. 13, 2002, at A14.

121. As one commentator has suggested, "[T]he main cause of Argentina's troubles was homegrown: the combination of a fixed-exchange rate, fiscal profligacy and mounting debt is not 'neo-liberal.' It is simply bad policy—and all the more reason to avoid a different set of bad policies now." *Argentina's Devaluation: From Straightjacket to Padded Cell*, *supra* note 115, at 13; but see Krugman, *supra* note 89, at A21.

122. Despite approving a \$10 billion emergency loan to Argentina in April of 2001, Treasury Secretary Paul O'Neill later decided not to supply further funds to Argentina under the theory that "you couldn't create confidence in Argentina by pouring more money into it—that before it received any additional financial aid, the country needed to change the way it approached the real down-to-the-ground stuff." Michael Lewis, *O'Neill's List*, N.Y. TIMES MAG., Jan. 13, 2002, at 25; but see Krugman, *supra* note 89, at A21 (arguing that the United States, "who previously encouraged Argentina in its disastrous policy course [were] now busily rewriting history, blaming the victims").

123. See discussion *supra* note 83 and accompanying text (explaining how the creation of independent central banks has strengthened democracy by furthering rationality, predictability and accountability in monetary policy-making).

124. See VON JHERING, *supra* note 55, at 472.

125. See discussion *supra* subsection III(C).

126. VON JHERING, *supra* note 55, at 472 (emphasis added).

tally important.<sup>127</sup> This Note reveals why it is legally and economically sensible to remove interest rate decision-making from the hands of electorally oriented public officials.

Finally, though the study of legal form does not offer a well worked out or fully operational plan to explain just how other similar structural changes can be made,<sup>128</sup> it constitutes a useful analytical tool for evaluating similar form-oriented reform proposals.<sup>129</sup> To those interested in state reform and especially state-initiated/self-binding experiments, the need for attention to appropriate legal form cannot be overstated.<sup>130</sup> As the successes and failures of different self-binding monetary policies illustrate, makers of public policy certainly cannot afford to ignore the role of legal form and devote themselves solely to a focus on substance. After all, as the Argentina experience with a currency board illustrated, bad form can clearly corrupt substance altogether.

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127. Shepsle, *supra* note 76, at 20.

128. In fact, proponents of other theories of structural reform have for some time recognized the lack of a full-blown theory of structural reform. See, e.g., PRZEWORSKI, *supra* note 52, at 138 (indicating that his study of structural reform "had no theory of structural transformation, and [that] empirical evidence is scanty").

129. Blinder, *supra* note 75, at 73 (arguing in favor of extending the framework around monetary policy to fiscal policy); see also BUS. COUNCIL OF AUSTR., DISCUSSION PAPER NO. 2, AVOIDING BOOM/BUST: MACRO-ECONOMIC REFORM FOR A GLOBALISED ECONOMY (1999) (arguing that the move towards leaving changes in the tax system to an independent agency would make fiscal policy more flexible while still maintaining discipline), available at [http://www.bca.com.au/upload/newdirections\\_avoiding.pdf](http://www.bca.com.au/upload/newdirections_avoiding.pdf).

130. See discussion *supra* subsections IV(A)-(C).